# A Low Flat-Rate Tax is Inadequate in Conditions of Crisis

**Prof. Rumen Gechev, D.Sc.**

The introduction of flat-tax rate in Bulgaria in 2008 took place and without serious economic, social and political analysis. Neither the opposition at the time, nor the trade unions and non-governmental organizations reacted adequately to such a serious and, as it turned out, too risky change in the fiscal policy of the country. Only lone voices from the academia were heard, while a number of pseudoscientific organizations, financed by Soros and other external sources, went into a neoliberal euphoria. The absurd slogan "the less government, the better" appeared in the leading media in a way that tolerated no objections. The government's main argument was based on purely pragmatic considerations –collectability of tax would increase and business would be promoted, leading to more available funds for investments.

Essentially, flat-rate tax excludes differentiated tax policy for different levels of income, i.e. it is *a priori* antisocial. In absolute terms, the larger the income, the larger the tax gift is. To put it another way, the richer get even richer at the expense of families with medium and low income. Moreover, the tax-exempt minimum income was abolished, i.e. even social groups with critically low income began paying 10 % tax. Not even such "neoliberal" economies like those of USA and Great Britain have considered so antisocial approach. In the pro-regulation economic models of France, Germany and Italy or in the social-democratic countries – such as Sweden, Finland and Denmark, the progressive tax exceeds 40 %.

The abolition of a differentiated tax policy is not consistent with two particularly important features of the Bulgarian economic model: *First,* a Currency Board has been in force since mid-1997, which essentially prohibits the monetary policy of BNB (Bulgarian National Bank), i.e. we cannot use the monetary policy as a tool for adaptation of our economy to the changes in the globalizing world economy. Therefore, by introducing flat rate tax we voluntarily have abolished the macroeconomic policy insofar as the two main pillars of such a policy are the fiscal and the monetary ones. This is an important feature because almost all countries that have introduced the flat rate tax have retained their freedom to at least apply monetary policy as a means of response in an environment of intensive international economic relations. *Second,* even though their validity is quite controversial, certain positive effects could be realized, but only in the conditions of economic boom, i.e. when balancing of the budget occurs during times of increasing revenue and decreasing social spending. Unfortunately, economic theory and – to a greater extent – practice do not exclude the business cycle from the characteristics of contemporary economic development. Put differently, there have been, there are and there will be crises. The question is, have analyses been made on what the budgetary effects of flat-rate tax at a record low level of 10 % would be in conditions of economic crisis? Obviously not, because even without the help of econometric estimates, it is clear that the possible contraction of GDP, resulting in a significant drop in budgetary revenues and inevitable pressure to increase social security payments, would put to the test not only the budgetary balance, but also the entire financial and economic system of the country.

## Are the positive effects of low flat-rate tax indisputable, as claimed by the Bulgarian neoliberals?

Flat-rate tax is very familiar as a theory and an applied mechanism. It has its proponents and opponents, who essentially interpret differently one and the same economic and social indicators. The peculiar thing about its application domestically is that it is not only flat (universal, undifferentiated), but also – as we have noted – at a record low level of just 10 %. Therefore, the first question is "Is not this level too low?" In his study from 2004, A. Laffer explicitly emphasizes the features of the *"arithmetic"* and the "*economic*" effect of a reduced tax rate. The former is related to the reduction of tax revenue per tax base unit, whereas the latter is based on the implementation of stimulus measures, leading to an increase in production, employment and GDP.[1] Later on, on the basis of comparative statistical analysis of the level of taxation and the budgetary proceeds over a period of almost 100 years, including several presidential administrations, some of which were those of Harding-Coolage, J.F. Kennedy and R. Reagan, he justifiably emphasizes that the "combined effect" of simultaneous implementation of the arithmetic and economic effect is a variable quantity. This combined effect is greater for tax rate cuts that are brought in when higher levels are in force, e.g. from 70 % to 40 %, and vice versa – smaller when the cut is from levels of 15-25 %. This dependency can be referred to as *"decreasing economic effect at low levels of the tax rate"*. This, I believe, gives an answer to the question why in our conditions the actual effects are significantly lower than expected.

Flat-rate tax has different variants of application. In its "pure form", i.e. full comprehensiveness (exclusion of any tax preferences, lack of differentiation between income and corporate tax), it has been applied for now only in two countries – Bulgaria and Georgia. In all other cases, to some or other extent, are applied tools for differentiation, including: (a) tax exemption; (b) reduction of the taxable income depending on the level of income; (c) tax relief; (d) lower tax only for certain types of income, or (e) provision of tax credit.

I fully agree with the convincing conclusions of Peichi (2008), who claims that "While lower

*Table 1. Levels of flat-rate tax in select countries*

| Country | Year of introduction | Tax rate ( %) |
|---|---|---|
| Hong Kong | 1947 | 16 |
| Estonia | 1994 | 22 |
| Latvia | 1995 | 25 |
| Lithuania | 1996 | 27 |
| Russia | 2001 | 13 |
| Slovakia | 2004 | 19 |
| The Ukraine | 2004 | 15 |
| Romania | 2005 | 16 |
| Georgia | 2005 | 12 |
| Macedonia | 2007 | 12 |
| Iceland | 2007 | 35.7 |
| Mongolia | 2007 | 10 |
| Kyrgyzstan | 2007 | 10 |
| Bulgaria | 2008 | 10 |

*Source: Hoover Institute, USA*

[1] Laffer, A. The Laffer Curve: Past, Present, and Future. Backgrounder # 765, June 1, 2004, pp.2-5, from http://www.economist.com/opinion/displaystory.cfm?story_id = 3861190

rates have a noticeable effect on the taxation of higher incomes, they are not so manifest for lower incomes. The results depend on the chosen tax parameters and the dependent thereon distribution of revenue" and that "...the effective highest tax rate decreases for households with high income, but grows for households with low to average income".[2] In other words, the introduction of low flat-rate tax in its "classic guise", i.e. without any differentiations, inevitably leads to two interconnected results: *First,* stronger economic incentive due to an increase in the amount of disposable income in the population and businesses, and *second,* redistribution of the income for the benefit of households with higher incomes. In this way, the possible additional incentives for economy growth have their high social price – contraction of the income distribution and redistribution effect, which is guaranteed under progressive taxation. In his paper "Constitution of Liberty", the 1974 Nobel Laureate in Economics, Fr. Hayek, asserts that the percentage of the highest tax on the highest incomes must be commensurate with the share of tax revenues in the GDP.[3] This principle has been followed for decades in all developed market economies, including those applying the most liberal market model such as USA and United Kingdom. In a recent study of the English economist, Povey, it is shown that in 2008 the share of tax revenue to Britain's GDP was 39 % and the highest tax for people with highest incomes was 41 %, i.e. actually 2 % higher than the limit of the maximum highest tax rate recommended by Hayek.[4]

Particularly intriguing is the theoretical and applied experience of the United States, where neoliberal ideas were originally applied and at that on the widest of scales. At the end of the day, these ideas are related to providing direct and indirect incentives to large corporate business. This is in regard with the "tax revolution" of Laffer, the monetarism ideas of M. Friedman, the economy of supply, etc. By retrospectively analyzing the development of the highest tax rates in the period 1986-1995, Rabushka and Hall (2007) categorically dispute the effectiveness of their high levels and put forward a series of arguments in support of their thesis on the necessity of introduction of flat-rate tax in USA.[5] I believe that their thesis is internally contradictory and it is not supported by the real parameters in the development of US economy. I agree with their conclusion that the 1986 tax reform achieved promotion of investments and consequently made growth more dynamic; also, definite technological innovation was achieved, the incentives for entrepreneurship intensified and the conditions for expansion of the capital market improved. Some of the indicators used have been chosen selectively, while others have been interpreted unilaterally. The authors do not answer two important questions: (a) why the "Laffer" effects turned out to be significantly weaker than expected, and (b) why in the end the "tax revolution" led to alarming budget deficits.

They note that lower taxes at the highest and the average levels were applied for only four years (until 1990), when the newly-elected Republican administration of George Bush Sr., was forced to raise almost all taxes, including the highest income tax from 28 % to 31 %[6]. The reason for this was the announced programme for reduction

2 Peichl, A. (2008): Could the World be Flat? Simulating Flat Tax Reforms in Western Europe, p. 7, from http://deposit.d-nb.de/cgi-bin/dokserv?idn = 989578240&dok_var = d1&dok_ext = pdf&filename = 989578240.pdf
3 Hayek, F. Constitution of Liberty (1978), Chicago: University of Chicago Press .
4 Povey, R. A Modest Proposal for a UK Flat Tax, Feb'18, 2008, Oxonomics, access from http://oxonomics.typepad.com/oxonomics/2008/02/a-modest-prop-1.html
5 Hall, R., Rabushka, A. (2007) The Flat Tax, Second Edition, Hoover Institution.
6 Hall, R., Rabushka, A., quoted work, pp. 2-3.

of the budget deficit by $500 billion in a period of 5 years, with half of its reduction having been implemented using the tools for the highest tax rate. When Bill Clinton came into power, he began to fulfil his pre-election promises to build a "fairer" tax system and decisively contract the budget deficit, which – according to most leading American economists – was identified as the main reason for the destabilization of the macroeconomic balance and the loss of competitiveness. He left only the minimal rate of 15 %, raised the highest tax from 28 % to 39.6 % and introduced another three "interim" rates for the middle class, respectively, 28 %, 31 % and 36 %.

What were the results of these tax changes? They certainly do not support the theses of the mentioned authors that lower taxes at the average and the highest level automatically result in improvement of the business climate and the system of macroeconomic parameters. The real world points to the opposite: irrespective of the higher taxes at the end of Clinton's second term, a number of indisputable macroeconomic successes were achieved, including record budget surplus, low unemployment, improved trade balance, high growth of the GDP, significant increase of actual incomes and improvement of the Gini coefficient, i.e. achievement of a more uniform distribution of incomes, etc.

Naturally, the discussion remains open. Edwards and Mitchell (2008) defend the thesis that low flat-rate tax can and must be used as tool for maintaining a high level of competitiveness.[7] Right in the first chapter of their study they show as an example the finitary relation of low flat-rate taxes: economic growth in several countries that are members of what they call the "Flat-rate tax club", which includes Slovakia, Romania, Bulgaria and Estonia. Examples of the results after reduction of taxation (income and corporate) in Hong Kong, Singapore, Malaysia, Australia, Canada, etc are put forward.[8] Can these arguments be accepted uncritically insofar as it is actually evident that increased economic growth in the specified period is a consequence of tax cuts?

It is true that in a number of countries and groups of countries (OECD, EU) has been spotted a trend to reduce the average tax levels through lowering of the tax thresholds. For example, in the last ten years or so their average level in the EU has been reduced by roughly 14 % (from 38 % to 24 %), in the group of highly developed countries OECD by 11 % (from 38 % to 27 %) and in Iceland from 30 % to 18 %. But the results of the functioning of their economies in these tax conditions are not unambiguous. In a number of cases, the current results support the opposite theory instead, namely that taxes that are too low can put a serious strain on the economies when a period of financial and economic crisis sets in.

This proved to be especially true of the current crisis. Countries with low flat-rate tax such as Lithuania, Latvia and Estonia survive only thanks to huge foreign loans and an increase in their current budget deficits. Iceland is the most shocking example – far too liberal monetary and fiscal policies brought the country to a complete economic meltdown, which necessitated emergency nationalization of the banks, change of administration, massive foreign funding and with that a salutatory increase of the national debt, mass bankruptcies of companies and financial brokers, etc.

7 Edwards, C., Mitchell, D. (2008). Global Tax Revolution: The Rise of Tax Competition and the Battle to Defend It. Washington, D.C.: CATO Institute.

8 Edwards, C., Mitchell, D., quoted work, pp. 2-8.

And the reverse in China, for example, where the predominantly applied tax on corporate profits is 33 % (there are two more rates of 18 % and 27 % that apply to a limited circle of enterprises with activity of low profitability – rail transport, extractive industry, etc). Taxes on personal income are strongly differentiated from 5 % to 45 % for incomes above 100 thousand Yuan (around US $14,600). This does not hinder them in maintaining a GDP growth of 10-12 % in the last few years, in accumulating foreign currency reserves (mainly from a positive trade balance) in excess of 1 trillion dollars, in attracting a record volume of foreign investments and in moving into second place for exports in the world market. In this respect, it is worth referring to A. Pigou's brilliant analysis, which proves two main conclusions in regard to differentiated taxes: First, they are a necessity for every "civilized country" and second, the difference in tax levels between individual countries is not at all an important factor for the movement of capital.[9] The latter part is conformed in Bulgaria, where, as we have noted, the import of capital has been decreasing in the last year, while the export has been growing regardless of our low tax rates.

The arguments of Mitchell and Edwards[10] in support of their proposal for harmonization of the tax policy in the direction of reduction and standardization of taxes to ensure "fair competition" in the globalizing world market are not convincing. Yes, it does look like the two main tax systems existing now – *territorial* (most countries in OECD) and *global* (USA) – are putting American companies, operating overseas, at a disadvantaged position. In the USA the corporate tax is 35 %, whereas it is 12.5 % in Ireland, for example. American companies, which conduct business in Ireland, must pay 12.5 % once in the host country and then pay another 22.5 % in taxes in the USA (the difference between 35 % and 12.5 %) if they decide to repatriate the profits. Practice has shown, though, that this is more like a theoretical tax burden. As the statistics on taxation in overseas companies and subsidiaries shows, they either reinvest their profits in the country, where their main business is conducted, or they find enough other loopholes for transfer of profits that ensure the evasion of profit tax (transfer via offshore companies, transfer by means of a sham loan to the parent company, etc).

In addition to this, the competitive advantage would disappear if the recommended harmonization of tax policy is implemented. The recommendation for standardization of taxes on corporate profits and income can be defined as an unrealistic dream. Even in the EU, where a significant harmonization of the monetary mechanisms, the trade policy, the labour legislation, etc has been achieved, the fiscal policy remains a national priority and there are no signs that soon a trend of harmonization will come about. Let's not even mention the differences in the models of key players in the global market like China, Japan and India, for example. Therefore, there are enough available examples of countries that use significantly higher rates of progressive taxes, whose macroeconomic indicators are far better than those of the countries using flat-rate taxes.

## Results from the implementation of flat-rate tax in Bulgaria

The comparative analysis of the indicators of the conditions of the Bulgarian national economy provides sufficient evidence that the expectations for significant positive effects from the introduction of low flat-rate tax are

[9] See in more detail: Pigou, A. The Economics of Welfare (1932), Fourth Edition, London: Macmillan and Co.
[10] Edwards, C., Mitchell, D., quoted qork, pp. 73-91.

not justified. For example, it has not persuaded foreign investors to increase their investments here. According to the latest data from NSI (National Statistical Institute) and BNB, in 2008 direct foreign investments (DFI) came to EUR 5,430.2 million (16 % of GDP), whereas for the same period in 2007 they came to EUR 6,516.9 (22.6 % of GDP). In the last year (2009) their level dropped to just EUR 3.2 billion and the preliminary and forecast results for 2010 are sobering. For the first four months of 2010 DFI's are just EUR 168 million, which is over 100 % less than for the same period in 2009. Moreover, the export of capital is accelerating, with the net export of capital in the period January-March of 2010 is just EUR 22 million. Thus, the low flat-rate tax here has retained foreign capital neither in the pre-crisis year of 2008, nor in the conditions of crisis in 2009. Of course, this decrease is not due to the lower taxes. Rather, it demonstrated that changes in particular elements of the fiscal policy and the ineffective inclusion of these changes in the overall business environment do not lead to positive effects.

As I expected, the contraction of the taxes had a negative effect on the balance of our current accounts instead. The deficit in the pre-crisis year of 2008 increased from EUR 6,303.4 million in 2007 to EUR 8,278.4 in 2008 or by almost 2 billion Euros. It reached the critical threshold of 25 % of the GDP, which now puts our economy in serious mid-term difficulties, above all the danger of expending the country's foreign currency reserves. The fact that if in 2007 foreign investments here covered 103 % of the deficit according to this account of the balance of payments, then in 2009 this coverage is a mere 66 %, with the outlook being that worse is to come, gives us grounds for such fears. To put it differently, *now there is no counterbalance to the erosion of the foreign currency reserve at all*. Therefore, the "theoretical" schemes for increased competitiveness of our companies, which pay lower taxes, are not confirmed. On the other hand, the increased disposable income additionally incentivizes import. Since it is well known that we are many times behind in labour productivity in comparison with the developed countries of the EU and outside it, why is the normal reaction of the consumers to focus their interest on the higher quality, imported goods met with surprise?

The improvement of the balance of the current account to a certain extent in 2010 can be defined as "fortune in misfortune" and the reason for it is not flat-rate tax, but the strong contraction of household incomes as a result of the deepening crisis. This always leads to reduced consumer demand, including imported products, everywhere.

In the period 2008-2009, the combination of low flat-rate tax with the maintenance of too high a budget surplus at around 3 % of GDP looked strange. The claim that this is the only way to "cover" the trade deficit was unconvincing. *First,* it turns out that budget surplus is "necessary" both when foreign investments increase significantly (2006-2007) and when they contract significantly (2008-2009). *Second,* if we start with the USA, go through the EU and reach Japan and Australia, we can see a clearly expressed policy of increase in budget spending in order to deal with the crisis. In most of these countries, the budget deficit was around 3 % of the GDP and they did not hesitate to increase it to 4-6 %. The strange thing is that we follow a "unique" fiscal policy in these conditions. The Currency Board obligates us to maintain a zero deficit rather than a significant surplus. To me, this policy was reminiscent of a situation, where the fire is spreading, yet we are keeping the fire brigade in "reserve" until the flames spread even further and to a "sufficient" height. I, for one, do not know of a case in the global economic history, where a crisis was solved or prevented with a budget surplus.

The data from the Ministry of Finance on the implementation of Budget 2008, the first year after the introduction of flat-rate tax, did not support the optimistic expectations. In 2007 a panel of authors from the Institute of Market Economy forecast that "...it would not be surprising if the revenues from direct taxes (corporate and income) reach almost BGN 5 billion, compared with the current figure of around BGN 4.5 billion".[11] But what are the facts? From the data of the Ministry of Finance[12] (See Figure 1) it is evident that in 2008 the revenues from direct taxes were BGN 4,010 million, including BGN 2,059.6 million from corporate tax and BGN 1,950.6 million from taxes on the incomes of natural persons. In other words, this is almost one billion leva or 20 % less than those forecasts and 4.2 % below the revenues stipulated in the Budget 2008 Act. The domestic "neoliberals" probably remained "surprised" anyway that dreams and reality are rather different. In the second half of 2009 and the current 2010, we are witnessing a real crash in the revenue part of the budget, but this, of course, is mainly due to our inadequate policy in the conditions of a deepening crisis.

In the period 2007-2008 the revenue from corporate tax has risen by 22.8 % ( + BGN 383 million) and the revenue from personal income tax by 10.8 % ( + BGN 142 million). In regard to corporate tax we should take into account that the rate of 10 % was introduced back in January 2007 (or was 5 % lower than 2006). The effect in 2007

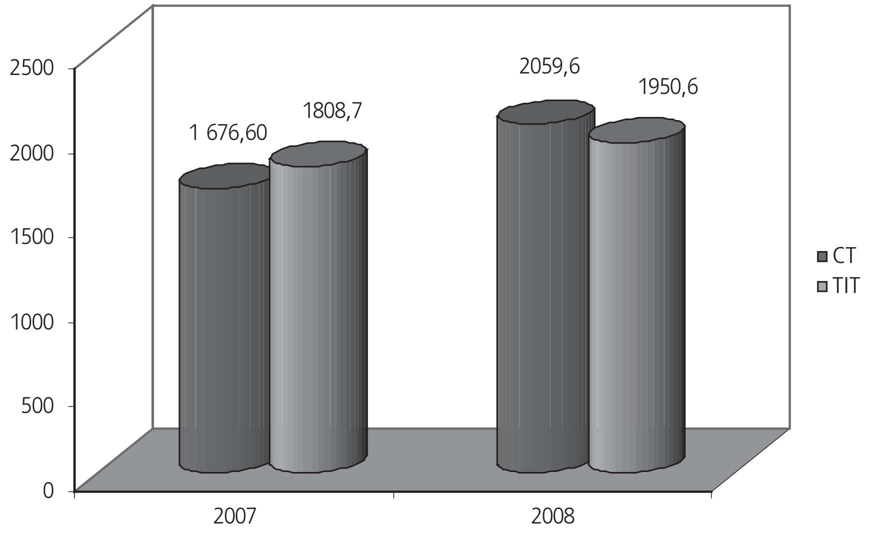


*Figure 1. Revenue from corporate tax and tax on the income of natural persons for 2007-2008 in millions of leva*
*Source: Ministry of Finance, Information bulletin, Implementation of the consolidated budget, December 2007 and December 2008.*
*Key: CT– corporate tax; TIT – total income tax for natural persons.*

[11] Kostadinova, S. I., Chobanov, D., Dimitrov, D., Mladenova, A., Metodiev, M. and Ganev, P. Draft budget for 2008: Review, analysis and recommendations. Flat-rate tax, Monthly bulletin on low taxes, October 2007, issue 26, p. 9.
[12] Monthly bulletin on the implementation of the budget – December 2008, Ministry of Finance.

was additional tax revenues from this tax in the amount of BGN 470.2 million, i.e. there is a trend of "dampening" of the effect and this trend deepened in 2009. We must definitely take into account two other key factors: first, the annual inflation and second, the economic growth, when we are determining the effects of lower taxes, especially those at critically low levels.

According to data of BNB[13], the average annual inflation is 12.4 %, whereas according to the preliminary figures of NSI[14], the rate of growth of the actual GDP was 7 %. Therefore, both factors push the nominal values of the economy upwards, also including the nominal numbers for tax revenues from taxation of companies and natural persons.

When these two factors are taken into account (See Figure 2 above), the "growth" of tax revenue from taxation of the incomes of natural persons is below the movement of inflation and growth, and those from corporate remain merely symbolic. As we have already noted, the growth from corporate tax revenues decreases in absolute terms in the second year after the introduction of 10 % tax. Put differently, it is possible that the adverse trend of decrease in the "arithmetic effect" from the tax cuts will deepen further, thus making the "economic effect" powerless.

In the second half of 2009 and the current 2010 we are witnessing a real crash in the revenue part of the budget, but this, of course, is mainly due to our

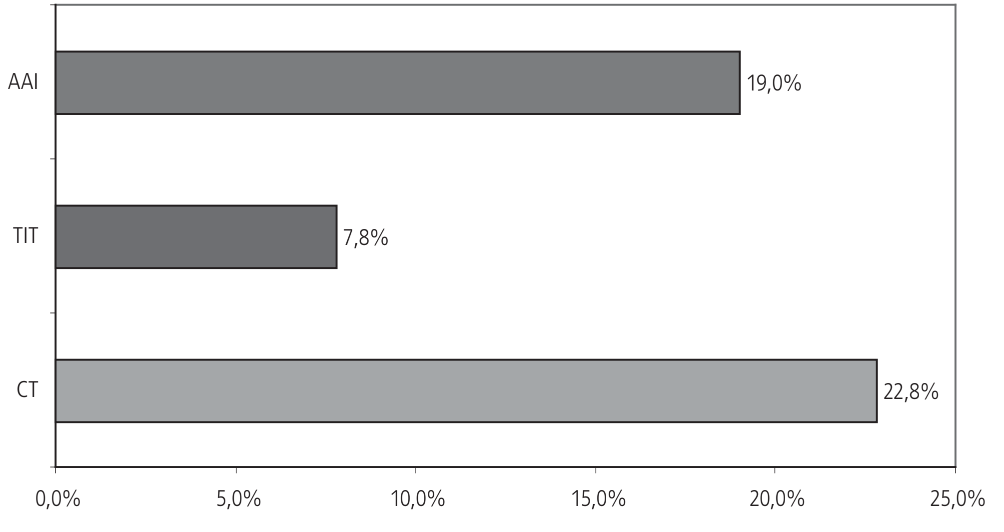


*Figure 2. Dynamics of inflation, GDP, revenue from corporate and income tax for 2008/2007 in percentages*
*Source: Ministry of Finance, Information bulletin, Implementation of the consolidated budget, December 2007 and December 2008.*
*Key: CT– corporate tax; TIT – total income tax for natural persons; AAI – average annual inflation and growth of GDP.*

13 BNB, macroeconomic indicators, from http://www.bnb.bg/bnb/home.nsf/fsWebIndexBul?OpenFrameset
14 NSI, key indicators for Bulgaria, from http://www.nsi.bg/KeyInd/KeyInd2008-12.pdf

inadequate policy in the conditions of a deepening crisis. According to data of the Ministry of Finance, the revenue under the Consolidated Fiscal Programme (CFP) at the end of 2009 are a bit over BGN 25 billion or 76.9 % of the planned revenue for the year. The proceeds are at 37.6 % of the forecast GDP in comparison with 40.9 % of the GDP for 2008. The proceeds come to BGN 20.2 billion, which is 78.4 % of the annual estimate. The revenue from direct taxes is BGN 3.8 billion or 77.1 % of the planned revenue. From the data on the condition of Budget 2010, and particularly after its forthcoming update, some conclusions and forecasts can be made:

***First,*** the opportunities for financing of the deepening budget deficit at the expense of the significant inherited fiscal reserve of BGN 8.2 billion are running out. Only in 18 months the current administration will bring it down to the critically low amount of BGN 4.6 billion. The question is how will the deficit be financed in the coming 2011? By taking on new domestic and foreign debt, by freezing or even cutting public sector pay, pensions and social benefits, by raising tax levels or by some combination thereof? The government's reluctance to promote ideas of tax hikes is understandable, since next year local and presidential elections will be held. But the worsening of most macroeconomic indicators, including the widespread unemployment, the continuing chain reactions of bankruptcies and the explosive growth of intercompany indebtedness shows that the rather likely crisis situation in the winter of 2011 may force the governing majority to resort to increase of taxes, because, on the one hand, the settlement of a new foreign debt requires enough time and, on the other hand, will be exceptionally costly under the current circumstances. It appears to me that the "Greek tragedy" makes such an exercise complicated and difficult to realize.

***Second,*** everywhere tax preferences are a widely used means of: (a) implementation of sector and industrial policy; (b) providing incentives for exporters; and (c) solving regional social economic problems. This is particularly necessary for promotion of business in conditions of crisis. Now the government cannot use such an approach to help the exporters and the importers of investment products with the aim of substitutive import. It is logical to expect that the possible increase of taxes will be seen as an element of an overall change in the fiscal policy that allows such differentiated promotion through tax reliefs and/or through direct or indirect subsidies – just like they do in the USA, Japan and Germany.

***Third,*** it can be said even now that the current unilateral policy to strongly contract all budget expenses will not produce a satisfactory result. The problem is not as much in the expenses, as it is in ensuring budget revenue. And budget revenue is a function of the economy, i.e. the centre of the fiscal policy in the conditions of crisis should be dependent on clear priorities for promotion of national production. Is it not indicative that neither the Republican Reagan in the 80's, nor the Democrat Obama allowed the failure of the American car industry and the crash of the banking system? The leading countries of the EU also put aside almost one trillion Euros for stabilization of their economies. Up to this point, the Bulgarian government has not announced even a single sensible measure for promotion of any business, never mind about a system of policies for coming out of the crisis.

***The updated in the middle of 2010 plan for budget revenues*** is unlikely to be realized. The growing unemployment, the dramatic contraction of foreign investments, the growth of court proceedings in connection with unpaid loans, the chain reaction of bankruptcies and the snowballing intercompany debts do not augur well. The government's position is unenviable in the light of a likely difficult winter, combined with an impossibility to use the tools for monetary and differentiated fiscal policy. Help from the EU is unlikely and now entering the Eurozone is not even dreamed of. Then what? The increase of taxes and their differentiation appears inevitable. The other alternative – exiting the Currency Board – would have even heavier consequences for the government. ИА